IFRS: Valuations in financial reporting

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What is IFRS and why relevant?

- Single set of accounting standards that can be used worldwide, benefits include
  - cross border M&A easier to effect
  - financial transparency – same profits throughout world, elimination of need for reconciliations between different profits
  - marketability of securities in different jurisdictions
  - easier to raise finance in different parts of world
  - consistency should improve dialogue between shareholders & analysts

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Worldwide application

- EU regulation
  - from 2005, for publicly traded companies
- In UK, DTI regulates
  - listed UK companies must comply from 2005
  - unlisted UK companies may comply if wish to, but UK GAAP will converge
- Most developed economies will apply IFRS from dates between 2005 & 2007 onwards

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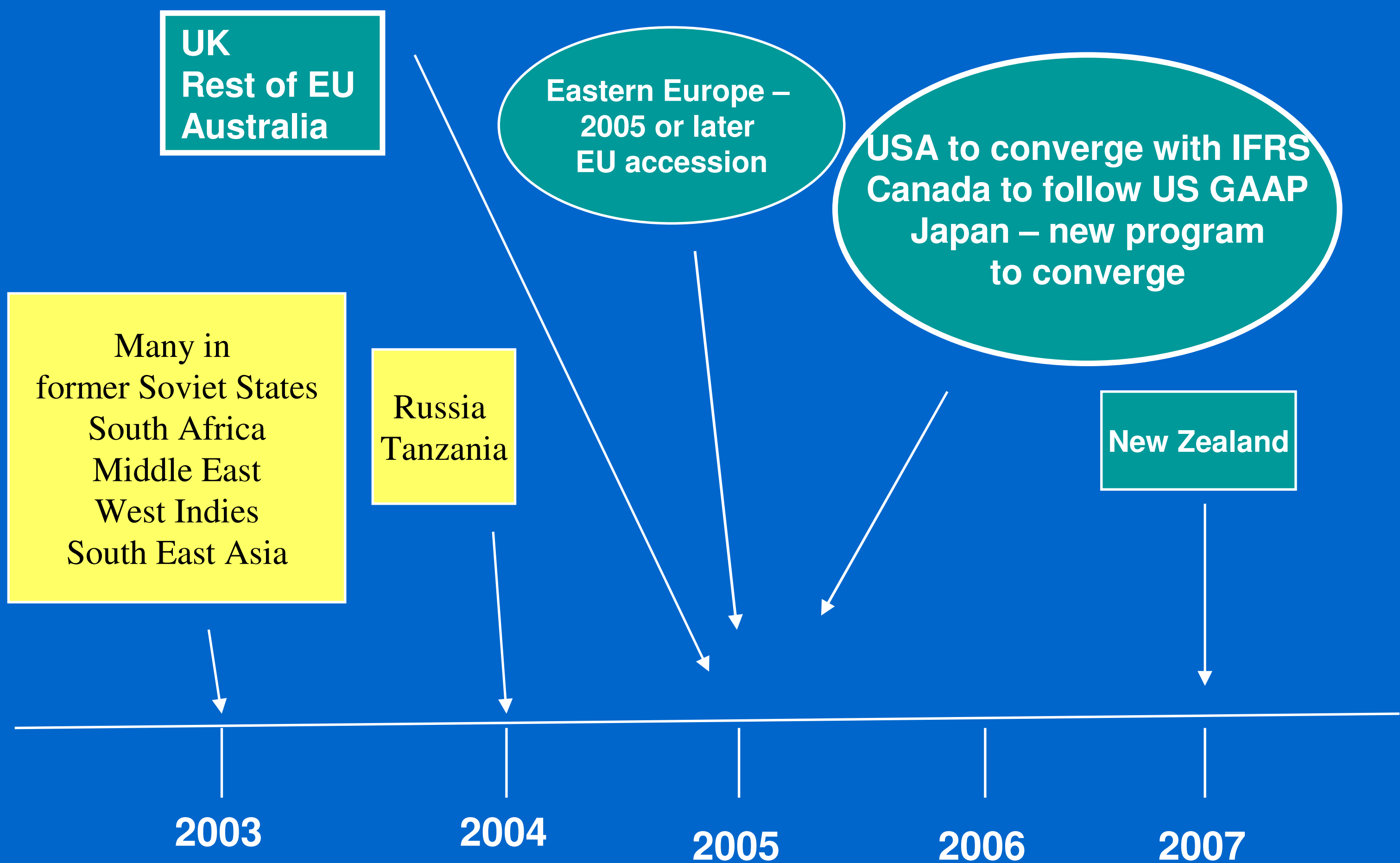
Transition programme



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‘Value’ in financial reporting

- Move from historical cost reporting to much greater emphasis on value – fair value, value in use, etc
- Value is more <u>relevant</u> information but has risk of being unreliable
  - new & revised IAS’s and IFRS’s aim to improve reliability of valuations in accounts
- Historical cost is more <u>reliable</u> information but can be irrelevant
  - e.g. amortisation of purchased goodwill over 20 years

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Key standards affected

- IFRS 3 – business combinations
- IAS 38 – intangible assets
- IAS 36 – impairment of assets such as property, intangible assets, goodwill

- IFRS 2 – share-based payments especially ESOPs
- IAS 39 – financial instruments, but will impact corporates as well as banks
- IAS 19 – pension fund accounting

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IFRS 3: business combinations

- All combinations to be accounted for as acquisitions not merger accounted
- Result is requirement to:
  - perform FV exercise on acquired company
  - identify purchased goodwill balance following all transactions
- Purchased goodwill may no longer be amortised, instead must be subject to annual <u>impairment test</u>

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Cost allocation: fair value exercise

Only recognise if FV can be measured reliably, assets/liabilities exist at acquisition date and pertain to acquiree

<u>Assets – other than intangible</u>
tangible assets and financial assets

<u>Liabilities – non contingent</u>

<u>Intangible assets</u>
Must satisfy IA definition in IAS 38:
-includes certain in-process R&D
-includes certain customer assets
- excludes teams of staff

<u>Contingent liabilities</u>

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IAS 38: intangible assets

- Most significant implications for IA's acquired as part of a business combination
- Acquirer must review acquiree for potential IA's and recognise most that are identified
- Acquirers will be more accountable for what they have spent on an acquisition:
  - smaller balances of purchased goodwill
  - larger balances relating to separately identified intangibles

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Fair Value measurement

Active market

- homogeneous items
- willing buyers & sellers constantly
- prices publicly available

yes

- quoted market prices
- valuation technique involving recent market transactions

no

- arm's length transaction between willing buyer & seller

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Absence of active market

<u>Methods involving current techniques & practices</u>

- Multiples of parameters driving profitability
  - revenue
  - market share
  - operating profit
  - royalty streams***
- NPV of net cash flows

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HSBC: acquisition of Household

Intangible assets arising on acquisition of Household International	UK GAAP $m	US GAAP $m
Intangible assets subject to amortisation		
Purchased credit card relationships and related agreements	47	1,404
Retail services merchant relationships	-	277
Other loan related relationships	3	326
Technology, customer lists and other contracts	-	281
Intangible assets not subject to amortisation		
Trade name	-	715
Total intangible assets	**50**	**3,003**

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IAS 36: impairment

- Not dissimilar to FRS 11 in UK GAAP
- But test required every year for all purchased GW and indefinite-lived IA's
  - frequency of application much higher under IFRS
  - most companies rather than just a few will need to be familiar with it

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Definition of impairment

- An impairment is recognised when the carrying value of an asset exceeds its <u>recoverable amount</u>
  - NB this is different from the Fair Value model

- Recoverable amount is

FV less costs to sell

- *higher* of

value in use (NPV)

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Determination of 'FV less costs to sell'

Amount obtainable from sale between knowledgeable willing parties less disposal costs

Valuation hierarchy

i. price in binding sale agreement
ii. if traded in active market
    - market price (bid price) less disposal costs
    - price of most recent transaction, assuming no subsequent change in economic circumstances
iii. if no active market, best information available including outcome of recent transactions in similar assets

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Determination of NPV

- Strict rules similar to FRS 11 apply in determining NPV
- DCF exercise with restrictions on:
  - size of sub unit of business to which DCF is applied "cash-generating units"
  - length of explicit forecast period
  - size of long-term extrapolated growth
  - which cash flows may be included – capex, reorganisation
  - assumptions consistent with market expectations
  - discount rate to be used

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Disclosure requirements

- To make review more robust, disclose for all significant GW and indefinite-lived IAs
  - discount rate
  - key assumptions – e.g. short and long-term growth
  - sensitivity – size of variations in parameters that could cause test to be failed

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IFRS 2: share-based payment

- Primary impact on companies with employee remuneration/reward schemes that include shares or options
- Before IFRS 2 share options would only impact P/L if options were exercised
  – intrinsic value only
- Big change
  – all share options granted must be charged at FV in P/L at date of grant

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IFRS 2 consequences

- Companies with ESOP's will need to value share options
  - Standard makes reference to both Black & Scholes and Binomial models
- For schemes with vesting periods, FV at grant date is spread over vesting period in P/L account
- Reported profits will be hit even if options are never exercised
- Some companies may remove the schemes
  - Microsoft has announced that it will no longer use ESOPs to reward employees

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IAS 39: financial instruments

- Most controversial standard with much in press
- Value reporting relevant to:
  - derivatives and embedded derivatives
  - option to carry any financial instrument at FV through profit – most applicable to banks
  - measurement of impairment of financial instruments – i.e. bad debt provision

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Derivatives and embedded derivs

- All derivatives to be carried at FV with changes in P/L account
- Rules also apply to derivatives embedded in another contract – e.g. a lease with option to extend term at non-market rates
  - searching for embedded derivatives will be difficult
- Rules will apply to any company using derivatives to hedge risks
  - e.g. interest rate swaps, FX swaps

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Fair Value determination: hierarchy

Is a quoted price/rate in an active market available?

Yes

Use quoted market price/rate from active market

- Quoted current **price** must be used if available
- if current bid/offer prices not available, use price of most recent transaction, subject to appropriate adjustments
- if market quotes a **rate** not a price, use the rate as input into a valuation technique

No

Use a valuation technique

- only used if quoted price in active market is not available.
- objective of technique is to establish what the transaction price would have been at measurement date in an arm's length transaction motivated by normal business considerations
  - maximise use of market inputs and minimise entity-specific inputs
- valuation techniques include:
  - recent arm's length market transactions between knowledgeable, willing parties
  - reference to current FV of another instrument that is substantially the same
  - DCF analysis
  - option pricing models

  If there is a valuation technique commonly used by market participants to price the instrument and that price has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique

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Impairment of financial instruments

- Covers impairment of loans and receivables
  - anticipated recoveries to be discounted at "Effective Interest Rate"
- Also covers impairment of equity investments
  - use IAS 39 to review whether impairment exists
  - use IAS 36 to quantify impairment

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Defined benefit pension funds

- Plan assets to be carried at FV
  - assumptions to be made re expected return on plan assets
- Plan liabilities to be measured at PV
  - actuarial assumptions on mortality etc required for estimation of liabilities

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IFRS valuation requirements

- Summary
  - Valuation and financial reporting to become closely linked
  - IASB interested in valuation methods & techniques – complex valuations are now required
  - An Exposure Draft to be issued at some stage on FV measurement issues
    - Likely to cover hierarchy of methods to apply

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